

**DRAFT**

No. O-02-088  
August 9, 2002

## I. Questions

2. If such payments are attributed to MPHS, such that MPHS is a source of income to Director Hanko under section 87103(c), does Director Hanko have a disqualifying conflict of interest in MPHS with respect to decisions directly impacting MPHS?

2. Yes. The purchaser, MPHS, is a source of income to Director Hanko under section 87103(c), and Director Hanko has a disqualifying conflict of interest in MPHS.

<sup>1</sup> All further statutory references are to the Government Code, unless otherwise specified.

### III. Facts

We first note that the Commission is not a finder of fact and accepts as accurate, for purposes of this opinion, those facts initially presented by this requestor.<sup>2</sup>

#### **The District:**

The Peninsula Health Care District (“District”) is a local health care district organized under the provisions of the California Health and Safety Code §§ 32000 et seq. For more than a year, the District has been negotiating a contractual “restructured relationship” with Mills Peninsula Health System (“MPHS”), a wholly owned subsidiary (as that term might apply in the non-profit sector) of Sutter Health (“Sutter”). Both MPHS and Sutter are California non-profit public benefit corporations. MPHS is a local entity operating the San Mateo health system, which consists of the merged operations of Peninsula Hospital and Mills Hospital. Sutter is a large multi-hospital system. MPHS affiliated with Sutter in January 1996.

In 1985, the District entered into a 30-year lease of its hospital, Peninsula Hospital in Burlingame (the “Hospital”), with MPHS, pursuant to which MPHS operated the Hospital and the District became the landlord. In 1997, the District commenced litigation against MPHS, seeking to invalidate the lease based on circumstances underlying the negotiation and execution of the lease. In 1998, while the litigation was pending, seismic safety regulations were issued by the state implementing SB 1953, legislation enacted in 1995, mandating earthquake structural integrity standards for California hospitals. After each conducted independent engineering studies, both the District and MPHS concluded that the Hospital would need to be replaced with a newly constructed facility. Recent amendments to the original legislation mandate replacement of the facility by the year 2013. The District and MPHS then began to negotiate a resolution of the issues created by SB 1953 and the lawsuit.

The negotiations between the District and MPHS were aimed toward a global settlement of the litigation by which MPHS (assisted with financing from Sutter) would construct and operate a new hospital on land leased from the District, subject to terms guaranteeing specified community benefits and granting the District certain oversight responsibilities. In August of 2000, the District, MPHS, and Sutter approved a Letter of Intent incorporating preliminary terms of a global settlement, including dismissal of the District’s lawsuit. The District and MPHS are currently negotiating what would be final contractual terms of the “restructured relationship.” If the District, MPHS, and Sutter reach final contractual terms, the terms of the “restructured relationship” will be placed on an upcoming ballot for approval or disapproval by voters residing in the District.

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<sup>2</sup> “The Commission does not act as a finder of fact when it issues legal opinions. Our opinion is applicable only to the extent that the facts provided to us are correct and that all of the material facts have been provided.” (*In re Oglesby* (1975) 1FPPC 71, p. 7, n. 6.) This opinion is based on the facts that were presented in the initial request for advice from the Peninsula Health Care District’s General Counsel, Colin Coffey, by letter, dated March 15, 2001. These facts were included in staff’s memoranda dated May 24, 2002 and June 26, 2002, and were verified as the correct facts by Mr. Coffey.

The District's board of directors, including Director Hanko, will be called upon to give direction to the District's negotiators, including voting on certain agreements to be incorporated in the final deal, and to ultimately vote to approve or disapprove the final agreements with MPHS, which will likely include Sutter as a signatory to the main or ancillary agreements. Final approval will also encompass the dismissal of the pending litigation.

**Director Hanko and Baxter:**

Director Hanko was elected to the District board for the first time in November of 2000. Director Hanko is employed by Baxter Healthcare Corporation, a Fortune 500 company conducting business worldwide in pharmaceutical and healthcare supplies. She also owns stock that has a value in excess of \$2,000. Director Hanko is a "pharmaceutical products specialist" for Baxter. Her duties consist mainly of marketing certain Baxter pharmaceutical products to healthcare providers, including hospitals, long term care providers, surgery centers, and other health services providers. Her efforts on behalf of Baxter are focused on educating healthcare professionals in these various settings about Baxter products available to them, including product introductions and follow-up utilization and general information about the use of the products. Therefore, her representation of Baxter encompasses pre- and post-sales presentations. Director Hanko does not "take orders" or conduct actual sales transactions. Healthcare providers purchase Baxter products through independent specialty wholesale companies with whom the providers conduct orders and purchase transactions. The wholesale companies purchase and resell the Baxter products to these providers. MPHS purchases Baxter products in this manner. During calendar year 2000, MPHS purchases of Baxter products through the wholesale companies amounted to approximately \$387,400.

In addition to the salary from and investment in Baxter, her employer also provides a bonus payment based on overall sales of Baxter products within Ms. Hanko's territory. The company annually establishes budgets for projected sales of product groups within a territory. It then creates a formula based on a target that is a percentage of projected total sales for a representative's product group and territory. The target (e.g., 85% of projected gross sales for the calendar year) becomes a minimum threshold of overall product sales in the territory before any incentive income will be paid. If, during the year, the overall sales of the product group exceed the targeted percentage of projected sales, the representative may receive incentive compensation that increases with the amount of overall sales exceeding the minimum threshold target of gross sales. The budget and target sales formulas do not expressly take into consideration the individual efforts of Director Hanko because the company does not trace individual product sales to its representatives. Therefore, the budget and target sales formulas are based entirely on product gross sales performance within the representatives' territories.

The company reserves the right to, and occasionally does, change its projected sales budgets and threshold targets during the course of a year based on its evaluation of the company's health and changing market conditions. Likewise, the company reserves the right to cancel the incentive compensation program altogether, and employee representatives must acknowledge in writing that the incentive program creates no express or implied contractual right to extra compensation.

Baxter employs consultants who conduct regular surveys of Baxter product sales through the independent wholesalers that conduct actual orders and sales with providers, such as hospitals. Baxter can determine from these consultants the approximate gross sales of its products to individual purchasers. These estimates are approximate because of the method of data collection employed by the sales survey consultants. It is nevertheless possible to determine the approximate percentage of overall product sales in a given territory that are attributable to sales to a specific customer. In this manner, Director Hanco can estimate the percentage of overall Baxter sales in her coverage territory attributable to MPHS purchases at Peninsula and Mills hospitals. Based on the year 2000 incentive compensation she received, Director Hanco estimates that approximately \$1,000 of her total incentive compensation from Baxter could be attributed to MPHS purchases of Baxter products in 2000.<sup>3</sup>

#### **IV. Discussion**

In considering Director Hanco's request, the Commission is guided by overriding principles set forth in the Political Reform Act ("Act"). The purposes of the conflict of interest provisions of the Political Reform Act of 1974 are partially set forth in section 81001, which states these findings:

"The people find and declare as follows:

¶ . . . ¶

"(b) Public officials, whether elected or appointed, should perform their duties in an impartial manner, free from bias caused by their own financial interests or the financial interests of persons who have supported them. . . . [Section 81001.]

"The people enact this title to accomplish the following purposes:

¶ . . . ¶

"(c) Assets and income of public officials which may be materially affected by their official actions should be disclosed and in appropriate circumstances the officials should be disqualified from acting in order that conflicts of interest may be avoided. . . ." [Section 81002.]

These statutory provisions are interpreted and explained in *Consumers Union of U.S., Inc. v. California Milk Producers Advisory Bd.* (1978) 82 Cal. App. 3d 433, 443:

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<sup>3</sup> The Commission requested information concerning Director Hanco's incentive compensation attributable to MPHS for the year 2001, but Director Hanco declined to provide that information.

“The act seeks to protect all citizens from those who might govern in a financially self-interested manner. Public officials should perform their duties in an impartial manner free from the pressures and bias caused by their own financial interests. (§ 81001, subds. (a) and (b).) To implement those goals, the assets and income of public officials which may be materially affected by their official actions must be disclosed. In appropriate circumstances the officials should be disqualified to avoid conflicts of interest. (§ 81002, subd. (d).) To this end the PRA should be liberally construed to accomplish its purposes. (§ 81003.) The PRA seeks to bring a degree of credibility to government by providing that those who hold a public trust must act, and appear to act, ethically. Erosion of confidence in public officials is detrimental to democracy. The election and appointment of ethical public officials depends upon an informed, interested and involved electorate. To maintain confidence and to avoid public skepticism, conflicts of interest must be shunned.”

In light of these guiding principles, we begin with an examination of the statute at issue, section 87103(c). “In statutory construction cases, our fundamental task is to ascertain the intent of the lawmakers so as to effectuate the purpose of the statute.” *Estate of Griswold*, 25 Cal. 4<sup>th</sup> 904, 910 (2001). Section 87103 states:

“A public official has a financial interest in a decision within the meaning of Section 87100 if it is reasonably foreseeable that the decision will have a material financial effect, distinguishable from its effect on the public generally, on the official, a member of his or her immediate family, or on any of the following:

¶ . . . ¶

“(c) Any source of income, except gifts or loans by a commercial lending institution made in the regular course of business on terms available to the public without regard to official status, aggregating five hundred dollars (\$500) or more in value provided or promised to, received by, the public official within 12 months prior to the time when the decision is made.”

Nowhere in this definition is there a limitation that the source of income<sup>4</sup> must be the direct payor of the funds to the official. Nor is there a prohibition against attributing responsibility, where appropriate and possible to do so, to more than one source.

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<sup>4</sup> For purposes of the Political Reform Act, a public official’s income includes income which has been promised to the public official but not yet received by him or her, if he or she has a legally enforceable right to the promised

When such limitations have been deemed appropriate, the Act has been amended to reflect the limitation. For example, in 1984, the Legislature added section 87103.5, which expressly excludes most retail customers of a business engaged in retail sales to the public generally as sources of income to a public official who owns a 10% or greater interest in the business:

“Notwithstanding subdivision (c) of Section 87103, a retail customer of a business entity engaged in retail sales of goods or services to the public generally is not a source of income to an official who owns a 10-percent or greater interest in the entity if the retail customers of the business entity constitute a significant segment of the public generally, and the amount of income received by the business entity from the customer is not distinguishable from the amount of income received from its other retail customers.” (Govt. Code § 87103.5)

In 1991, the Legislature added section 87103.6, which expressly excludes as a source of income any person who pays application or processing fees to a public agency. Section 87103.6 states:

“Notwithstanding subdivision (c) of Section 87103, any person who makes a payment to a state agency or local government agency to defray the estimated reasonable costs to process any application, approval, or any other action, including but not limited to, holding public hearings and evaluating or preparing any report or document, shall not by reason of the payments be a source of income to a person who is retained or employed by the agency.”

This statute expressly excludes certain third-party transactions from the definition of “source of income” under section 87103(c). There would be no need to expressly exclude these third-party transactions from the definition if other third parties could not be sources of income. The rules of statutory construction support this conclusion.

“Under well-established rules of statutory construction, where an exception to a general rule is specified by statute, other exceptions cannot be implied or presumed [*expresio unius est exclusio alterius*]. [Citation omitted.] In other words, a statute that enumerates things upon which it operates is to be construed as excluding from its effect all those things not expressly mentioned.”

*Embarcadero Municipal Improvement District v. County of Santa Barbara*, 88 Cal. App. 4<sup>th</sup> 781, 793 (2001).

Under this rule of statutory construction, a third party, under the appropriate circumstances, can be a source of income within the meaning of section 87103(c).

The Commission has considered third party payments in the context of commission income as well. “Commission income” is defined in regulation 18703.3(c)(2) as “gross payments received as a result of services rendered as a broker, agent, or other salesperson for a specific sale or similar transaction.” Under this regulation, not only is an employer or business a source of income to an official, but also any client who is a party to a transaction.

Director Hanko’s incentive compensation payment does not qualify as commission income, because the incentive compensation payment is based on the volume of sales. However, nothing in the Act precludes us from applying section 87103(c) to Director Hanko’s situation, and doing so would be consistent with our reading of “source of income” in other circumstances and with our statutory mandate to “liberally construe[]” the Act to avoid conflicts of interest.

Director Hanko has estimated that the portion of her incentive compensation for the year 2000 attributable to purchases made by MPHS is approximately \$1,000. Thus, the issue is whether MPHS may be considered to be the source of that income.

Director Hanko’s incentive compensation is based on her directed sales or marketing efforts, similar to the efforts of a “broker, agent, or other salesperson,” as referenced in regulation 18703.3(c)(2), and should be similarly treated under the Act. Therefore, we find that where a public official is employed to direct sales or marketing activity toward a business entity such that there is a direct relationship between the purchasing activity of the entity and the amount of the incentive compensation the official receives, then the business entity will be a source of income to the public official.

“Incentive compensation,” as described above, is an additional sum of money paid over and above a base salary, based solely on results achieved by the individual as a product of his or her efforts, and typically measured against pre-determined goals set by the employer. It differs from “commission” in that it is not based on a specific sale or similar transaction, and differs from a “bonus” in that it is not a singular event, but is ongoing and/or cumulative as sales or purchases accumulate. Thus, the incentive income, like a commission, is ultimately determined based on the conduct of the purchaser in direct response to the efforts of the public official.

This definition of “incentive compensation” expressly excludes salary. Typically, salary is a guaranteed payment to an employee of a pre-set sum of money to perform the tasks of the job to which he or she is assigned. This amount does not vary based on the employee’s actions or those of the employer’s clients.

Director Hanko argues that MPHS is not a source of income to her because MPHS is not a direct customer of her employer, but rather purchases Baxter products through a wholesale

supplier, not directly from Baxter. This is at best an argument of semantics. Director Hanko knows that her employer has an incentive compensation program that is tied to purchases made in a defined geographical area that includes MPHS. Director Hanko is a highly skilled, highly trained, knowledgeable member of a pharmaceutical sales force employed by Baxter specifically to market its products to MPHS and others. She shares her knowledge with employees and independently contracted physicians at a local hospital operated by MPHS. MPHS is a de facto customer of Baxter because MPHS runs the pharmacy, places orders with the wholesaler, and buys and dispenses Baxter products. Ms. Hanko is aware that there is a potential financial impact on her personal finances from her daily dealings with MPHS in trying to promote her company's products, and she knows that part of her pay is due to the purchases by MPHS. Ms. Hanko also sits on a board that is considering matters having a very significant financial impact on MPHS.

Based on the facts presented to us, we find that payments from Baxter, her employer, to Director Hanko will be attributed to MPHS, a purchaser of her employer's products, because Director Hanko:

- 1) has been employed to purposefully direct sales or marketing activity toward the purchaser;
- 2) there is direct contact between Director Hanko and the purchaser intended by Director Hanko to generate sales or business; and
- 3) there is a direct relationship between the purchasing activity of the purchaser and the amount of the incentive compensation received by Director Hanko.

Because these requirements are met, both the purchaser and the employer are sources of income to Director Hanko for purposes of sections 87100 and 87103.<sup>5</sup> Because MPHS is a source of equal to or more than \$500 income to Director Hanko, she has a disqualifying conflict of interest in decisions directly involving MPHS. (Regulation 18704.2.) Therefore, Director Hanko may not participate in the negotiations and vote regarding the hospital lease.<sup>6</sup>

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<sup>5</sup> The Commission does not here decide the impact of this opinion on the disclosure requirements of section 87207. We note only that there have been other situations in which we have pierced the first layer to find that a public official had an economic interest in a third party, but did not require disclosure under section 87207. For example, in *In re Nord*, (1983) 8 FPPC Ops. 6, we found that a public official who was a limited partner had an economic interest in not only his controlling general partners, but also in "any other business entity in which either Smith or Jones or both act as a controlling general partner or controlling shareholder. . . ." Thus, we said, disqualification was required in those cases. However, we did not require that the public official disclose such third parties as sources of income.

<sup>6</sup> The *Larsen* Advice Letter, No. I-89-555 is superseded to the extent that the party receiving the bonus payment was not employed to direct sales or marketing activity toward the purchaser. It is further superseded to the extent that there was no direct contact between he and the purchaser intended to generate sales or business. For these reasons, under the incentive compensation scheme of *In re Hanko*, the farmers in the fact pattern presented in the *Larsen* Advice Letter would not be treated as sources of income. The *Anaforian* Advice Letter, No. I-90-312, *Coffey* Advice Letter, No. A-01-064, and *Brown* Advice Letter, No. A-01-286, are unaffected by this opinion.



Approved by the Commission on August 9, 2002. Concurring: Chairman Getman, Commissioners Downey and Swanson. Dissenting: Commissioner Knox.

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Karen A. Getman  
Chairman